OFFICE OF
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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: Applicability of Manufacturer's Exception Under Proportionate Disallowance Rule

This Field Service Advice responds to your memorandum dated May 18, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer =
Year 1 =
Year 2 =
Year 3 =

ISSUE:

Whether Temp. Treas. Reg. § 1.453C-10T is a valid interpretation of section 811(c)(2) of the Tax Reform Act of 1986, relating to obligations arising from certain installment sales by manufacturers to dealers, because in drafting the regulation the Treasury Department limited the statute's scope so as to benefit a single taxpayer, in contravention of the statute's wording but in accordance with what was perceived to be congressional intent?

CONCLUSION:

We believe that Temp. Treas. Reg. § 1.453C-10T is valid; it is not unreasonable or plainly inconsistent with Congress's intent in enacting section 811(c)(2).

FACTS:

Taxpayer is a manufacturer which sells through dealers. Appeals is considering refund claims filed by Taxpayer for taxable Years 1, 2, and 3. Taxpayer used the installment method for reporting sales to its dealers under I.R.C. § 453 prior to Year 1. Taxpayer used the installment method for Year 1.

LAW AND ANALYSIS

Prior to enactment of the Tax Reform Act of 1986, I.R.C. § 453A provided that persons who regularly sell or otherwise dispose of personal property on the installment plan could report the gain derived from such sales in the taxable year in which the installment payments attributable to the sale were received, i.e., the installment method of accounting. The term "sale on the installment plan" meant a sale by a taxpayer under any plan for the sale or other disposition of personal property which by its terms and conditions contemplated that each sale under the plan would be paid in two or more payments. Treas. Reg. § 1.453-2(b)(1). In general, the reporting of gain on the installment method was permitted primarily because the seller might be unable to pay the tax currently, as no cash may be available until the payments under the obligation were received. See General Explanation of the Tax Reform Act of 1986 (Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess. 489 [May 4, 1987]).

The Tax Reform Act of 1986, Pub. Law No. 99-514, §§ 811-812, 100 Stat. 2085, 2365-72 (1986), enacted the proportionate disallowance rule of I.R.C. § 453C, which greatly limited the availability of the installment method. The proportionate disallowance rule affects sales by dealers in personal property under an installment plan.

The proportionate disallowance rule requires a portion of the seller's outstanding borrowings to be treated as payment on certain installment obligations held by the seller. To the extent that the seller incurs loans (from borrowings which were assumed to be related to the receivables under the installment obligations), a pro rata portion of the seller's outstanding loans is treated as a payment on the installment obligations received during the year and still outstanding at the close of the year. This has the effect of treating a portion of a taxpayer's debt as a payment toward its installment obligations ("deemed payment"), thereby accelerating a

portion of the gain that otherwise would have been deferred under the installment method.

The proportionate disallowance rule applied only to dealer sales occurring after February 28, 1986, and before January 1, 1988. Temp. Treas. Reg. § 1.453C-10T, Q&A 1. It was enacted because Congress believed that the ability to defer taxation under the installment method is inappropriate in the case of gains realized by dealers on ordinary income assets, to the extent that a taxpayer has been able to receive cash from borrowings related to its installment obligations. See S. Rep. No. 313, 99th Cong., 2d Sess. 123 (1986).

The following year Congress repealed I.R.C. § 453C when it decided to disallow all dealer installment sales. Section 10202 of the Revenue Act of 1987 (Pub. Law 100-203, 101 Stat. 1330) repealed I.R.C. § 453C for dealer dispositions, effective as to dispositions after December 31, 1987. However, Congress provided an exception to I.R.C. § 453C for manufacturers who sold on the installment basis to dealers.

Congress exempted certain installment obligations that satisfy the requirements of section 811(c)(2) of the Tax Reform Act of 1986 from the requirements of the proportionate disallowance rule of I.R.C. § 453C and the repeal of the installment method. Thus, income from such obligations may be taken into account under the installment method of accounting allowed under the Code as in effect prior to the Tax Reform Act of 1986 if the method was otherwise available to the taxpayer. In pertinent parts, section 811(c)(2) provides as follows:

> (2) Exception for Certain Sales of Property by a Manufacturer to a Dealer.–-
>
> > (A) In General – The amendment made by this section shall not apply to any installment obligation arising from the disposition of tangible personal property by a manufacturer (or any affiliate) to a dealer if–-
> >
> > > (i) the dealer is obligated to pay on such obligation only when the dealer resells (or rents) the property,
> > >
> > > (ii) the manufacturer has the right to repurchase the property at a fixed (or ascertainable) price no later than the 9 month period beginning with the date of the sale, and

> (iii) such disposition is in a taxable year with respect to which the requirements of subparagraph (B) are met.
>
> (B) Receivables Must Be At Least 50 Percent of Total Sales–-
>
> (i) In General.--The requirements of this subparagraph are met with respect to any taxable year if for such taxable year the aggregate face amount of installment obligations described in subparagraph (A) is at least 50 percent of the total sales to dealers giving rise to such obligations. (Emphasis added).

Section 811(c)(2) resulted from amendments to the House bill proposed by the Senate. The wording of section 811(c)(2) was virtually identical to the amendment the Senate proposed to the House bill.

The Senate Report accompanying its proposed amendments to the House bill, including its draft of section 811(c)(2), stated that to be excepted from the proportionate disallowance rule, "the aggregate face amount of the installment obligations that otherwise qualify for the exception must equal at least 50 percent of the total sales to dealers that give rise to such receivables (the 'fifty percent test') in both the taxable year and the preceding taxable year...." Further, the Senate Finance Committee Report stated that "for purposes of applying the fifty percent test the aggregate face amount of the taxpayer's receivables is computed using the weighted average of the taxpayer's receivables computed on a monthly basis." S. Rep. No. 313, 99th Cong., 2d Sess. 130 (1986). The conference agreement generally followed the Senate's proposal, with certain modifications not relevant to the 50 percent test exception to the proportionate disallowance rule. See H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess., 297-99 (1986).

Following enactment of section 811(c)(2), Temp. Treas. Reg. § 1.453C-10T was promulgated to interpret this statute via a question-and-answer format. See T.D. 8213, filed July 11, 1988. It provided, inter alia, that for purposes of the "50 percent test," the aggregate face amount of the taxpayer's obligations is computed by using the "average balance of outstanding eligible obligations, calculated on a monthly basis." Temp. Treas. Reg. § 1.453C-10T, Q&A 5.

Taxpayer argues that the regulation is invalid as it conflicts with the express language of section 811(c)(2). Taxpayer argues that section 811(c)(2) is clear on its face when it calls for calculating the 50 percent test of outstanding installment obligations using “total sales to dealers giving rise to such obligations.” According

to the Taxpayer, the regulation's calculation of the 50 percent test of outstanding installment obligations using the "average balance of outstanding eligible obligations, calculated on a monthly basis," is inconsistent with the statute. The statute contemplates an annual calculation, the regulation a monthly one. Given the statute's express terms, the regulation's inconsistency renders it invalid.

In analyzing the validity of Temp. Treas. Reg. § 1.453C-10T, we must begin by looking to the tests applied by the courts for determining the validity of regulations. As the Supreme Court stated in Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 842-843 (1984):

> When a court reviews an agency's construction of the statue which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the Court determines Congress has not directly addressed the precise question in dispute, the court does not simply impose its own construction on the statute . . . .
>
> Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.

Furthermore, it is well-settled that a regulation, to be valid, does not have to be the best interpretation of a statute but only must be a reasonable interpretation. See National Muffler Dealers Association v. U.S., 440 U.S. 472 (1979), where the Court declared that a tax regulation was invalid if it failed to implement the congressional mandate in a reasonable manner. In determining whether a particular regulation carries out the congressional mandate in a reasonable manner, the courts look to see whether the "regulation harmonizes with the plain language of the statute, its origin and its purpose." National Muffler Dealers Association, 440 U.S. at 477.

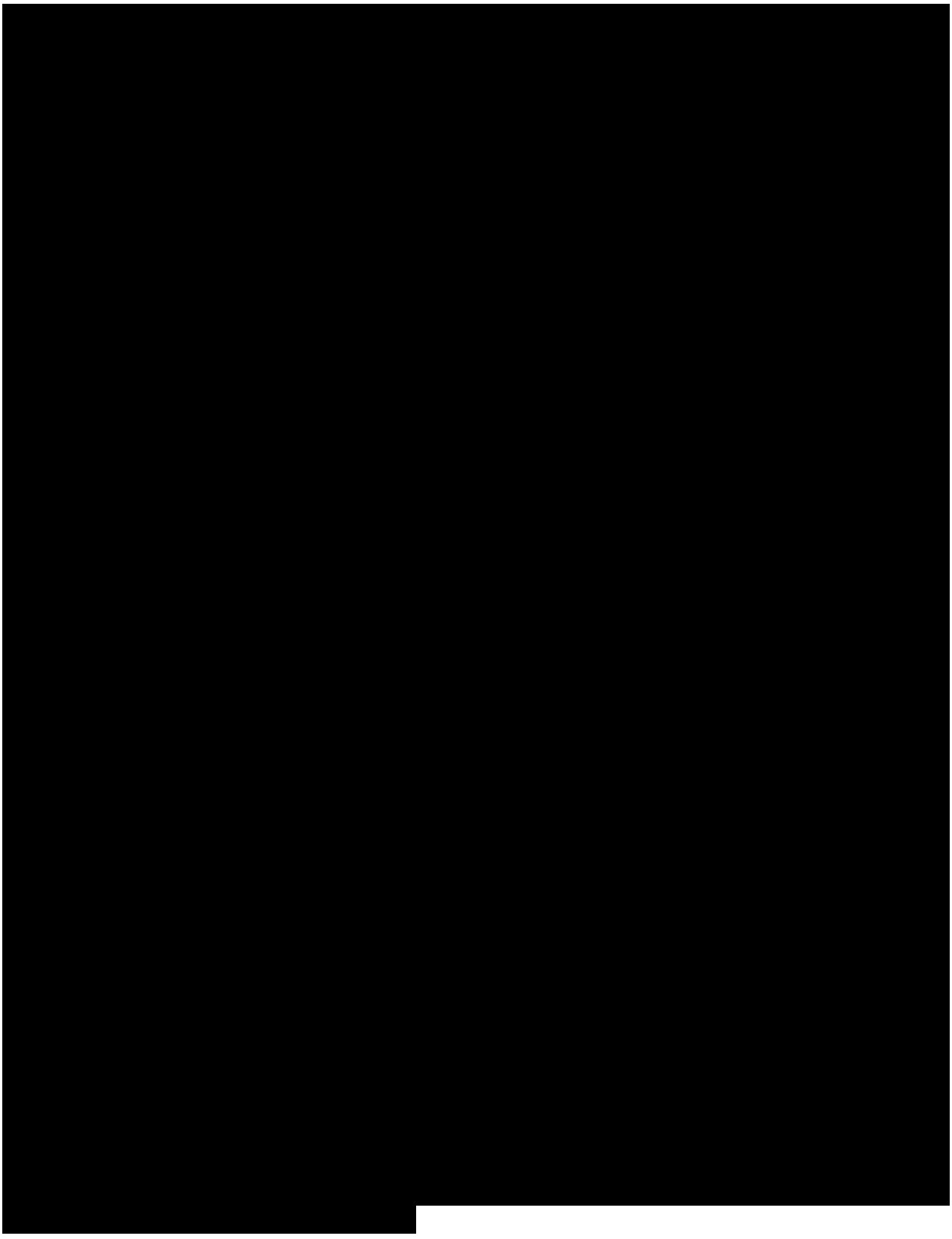
The starting point for determining whether a regulation satisfies the requirements for validity is the statutory language itself. See Southeastern Community College v. Davis, 442 U.S. 397, 405 (1979). It is our view that Congress intended for purposes of applying the "50 percent test" of section 811(c)(2) that the aggregate face amount of the taxpayer's receivables be computed using the weighted average of the taxpayers' receivables computed on a monthly basis.

In drafting section 811(c)(2), the Senate, not the House, proposed exempting certain manufacturers from the proportionate disallowance rule of I.R.C. § 453C. In making the proposal, the Senate drafted statutory language, which required satisfaction of a 50 percent test and other requirements for entitlement to the

exception. The Senate's amendment (in the form of a draft statute) stated that to meet the 50 percent test, the "aggregate face amount of the installment obligations that otherwise qualify for the exception must equal at least 50 percent of the total sales to dealers that give rise to such receivables." In the Senate report that accompanied its amendment, the Senate explained the manner in which the 50 percent test is applied. The Senate report stated that "for purposes of applying the fifty percent test the aggregate face amount of the taxpayer's receivables is computed using the weighted average of the taxpayer's receivables computed on a monthly basis." The conference adopted the Senate amendment without any modifications relevant to manufacturer's exception. Furthermore, the Senate's amendment (the draft statutory language) regarding the "50 percent test" is identical to the language regarding the "50 percent test" ultimately adopted in section 811(c)(2).

In providing that for purposes of the "50 percent test" of section 811(c)(2) the aggregate face amount of the taxpayer's obligations is computed by using the average monthly balance of the otherwise qualifying obligations, Temp. Treas. Reg. § 1.453C-10T was consistent with the language, purpose, and origin of section 811(c)(2). Therefore, we believe that the regulation was a valid interpretation of section 811(c)(2).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:



If you have any further questions, please call 202 622-7900.

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By: _____

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